

# Getting set for Solvency II

*Comparing goals  
and benchmarking  
progress on Solvency II  
implementation across  
Europe*

*November 2010*



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# Introduction

*The European insurance industry is bracing itself for the most significant change to the regulatory and supervisory environment in living memory. Every insurance and reinsurance company operating in the European Economic Area (EEA) will be affected and there will also be implications for companies outside the EEA.*

*Getting set for Solvency II* outlines the findings of a survey looking at European insurers' readiness for implementation. The survey aims to provide a benchmark against which you can compare your own progress.

The findings reveal that the state of preparedness varies quite markedly. A significant proportion of respondents have ambitious plans for Solvency II, but only 25% see the directive as an opportunity to sharpen competitive differentiation. At the other end of the spectrum, quite a few respondents have made very little progress at all. Even among many of the front runners, the survey highlights concerns over resources and the adequacy of internal communications programmes within the business.

We would like to thank all the participants for taking the time to complete the survey. We hope that you find the results and the surrounding analysis a useful aid to implementation.

## About this survey

The findings are based on the responses of 115 companies to an online survey conducted by PwC over the summer and autumn of 2010 (see page 26 for a breakdown of participants). The questions covered a range of topics including ambitions for Solvency II, critical success factors and progress against objectives. The survey also sought respondents' views on the readiness of their supervisors.



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# Executive summary

*Most respondents are keen to capitalise on the opportunities opened up by Solvency II, with a large majority having ambitions that go beyond basic compliance. However, most projects are largely internally focused at present. Few are looking to engage with analysts, rating agencies or other external stakeholders, apart from their supervisors, at this stage.*

Most respondents rate board commitment highly. However, many are finding it difficult to embed Solvency II and their surrounding plans into the culture of the business, and have concerns over the quality and availability of internal resources.

The survey reveals widespread take-up of initiatives that can help to underpin the development of Solvency II, including enterprise risk management (ERM) and Economic Capital. Many respondents are aiming to align these projects with Solvency II to make the most efficient use of synergies and reduce costs. While many would like to make the most of convergence between Solvency II and IFRS, the differences highlighted in the recent IFRS exposure draft could create challenges (see PwC's *Getting to grips with the shake-up*, October 2010 - more details on page 29).

## **Cutting it fine**

Most respondents are confident that they'll meet the deadlines for Solvency II, though more than 40% are only in the preparatory stages or have not yet launched their projects.

Even those whose projects are underway do not necessarily have a clear idea of the level of human and financial resource needed. Although many respondents indicated that additional expertise would be required over and above their dedicated Solvency II teams, a significant proportion are not sure how much, or where it will come from. Many indicate that at least some of this support would come from outside their organisation, though this may be difficult as external resources are likely to become increasingly scarce as the deadline approaches.

Many respondents form part of a group and this may explain the lack of clarity over budgets. However, views vary considerably about where the main costs will lie. Rather surprisingly, over 80% of respondents think that less than half the total cost will relate to technology. If the budget estimates in this survey are in any way indicative of the overall cost to the industry in Europe, the total outlay could be significantly higher than the €3 billion the European Commission has anticipated.<sup>1</sup>



# 2

### ***Differing priorities***

Respondents' views of what they see as important and what they believe supervisors consider important differ quite markedly. Respondents' primary focus is the next challenge in their implementation programme, such as the availability and quality of internal resources, rather than the end game. They believe that supervisors are focused on governance, as well as the quality of modelling and data. Most respondents are confident that they already meet the required standards of governance, though this would appear to be at odds with the fact that most believe that the Own Risk and Solvency Assessment (ORSA) is still a significant challenge.

There also appear to be unrealistic expectations about how many models can be approved before Solvency II goes live. More than a third of respondents would like their internal models to have been approved when Solvency II goes live; with many hoping for multiple model approvals. This would indicate that each and every EEA supervisor would be expected to approve significantly more models than previously envisaged.

In spite of a few persistent concerns raised around data quality issues, the majority of respondents using internal models are quite confident about the quality and adequacy of their data. The responses suggest, however, that there may be a perception that data quality is an internal model, rather than general, issue.

### ***Supervisors on track***

The majority of respondents believe that their supervisors have adequate resources to undertake the supervisory review process, though more than 40% speak to their supervisors infrequently or not at all.

Smaller entities may have a limited impact on the overall capital evaluation of a large group, but may be highly important in the countries in which they operate. Paying less attention to Solvency II preparation in smaller entities may therefore attract extra scrutiny and questions from supervisors. Whether smaller entities are part of a group or not, the proportionality principle may apply to them, though the amount of effort that is required to comply does not depend on size, but rather the relative level of risk.

### ***Critical success factors for your Solvency II programme:***

- *Board oversight and commitment*
- *Availability and quality of internal resources*
- *Quality and availability of internal data*

### ***Top three challenges for successful implementation:***

- *ORSA (by a long way)*
- *Internal model approval*
- *Report to supervisors*

# QIS5

*The risk calibration levels in Quantitative Impact Study (QIS5) are based on the findings from QIS4 conducted in 2008, albeit that participation in the solo exercise was low. Participation in QIS5 will help to provide a more representative basis for setting the calibrations.*

QIS5<sup>2</sup> is the last full test of the likely impact of Solvency II on insurers' capital requirements before key calibrations are finalised and incorporated in the Level 2 implementing measures. A further QIS may be carried out in early 2011, but this will focus on specific issues only, depending on the results of QIS5 (to be published in the spring of 2011).

Many insurers have deep concerns about the potential impact of a number of calibrations included in the QIS5 technical specifications. All the calibrations were based on the results of the QIS4 exercise conducted in 2008. However, only 28% of all insurers in the EU participated in the solo QIS4 exercise (111 insurance groups participated in the group exercise – over 60% of all groups – but the scope of that exercise was limited). The European Commission, CEIOPS and the European industry association, Comité Européen des Assurances (CEA), have all repeatedly stressed the importance of firms' participation in QIS5, as getting the calibrations right depends on the quality of the data on which they are based.

Our survey suggests that participation in QIS5 will be higher than any of the previous studies, with 97% of respondents saying that they plan to participate in the exercise (see Figure 1). Overall, 50% are undertaking QIS5 at both the group and entity level: a further 40% at entity level alone. Only 7% are undertaking QIS5 solely at the group level. It should be noted that the respondents to this survey had considerably higher participation rates in previous QIS exercises than the general population (see Figure 2). But this is still positive news.

However, even with significant participation in QIS5, there could still be question marks over the quality or comparability of the results:

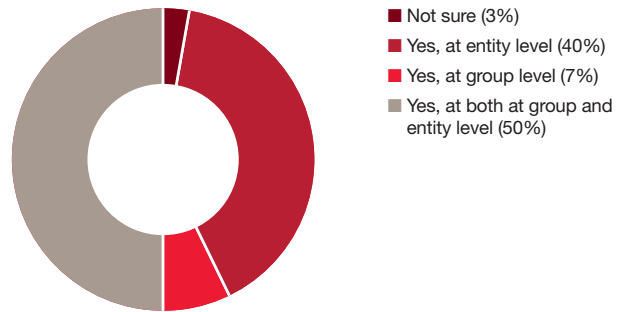
- Firms which have undertaken the QIS exercises in the past are better prepared to use 'real data' when undertaking the exercise, whereas those new to the exercise may be forced to adopt a 'best efforts' approach.
- There will be differences in the version of the spreadsheets being used for the QIS5 exercise, as some firms had already launched the exercise before the final version of the spreadsheets became available.

The differences in readiness and application may affect the quality and comparability of the results and in turn affect the calibrations adopted in the final Level 2 measures.

# 3

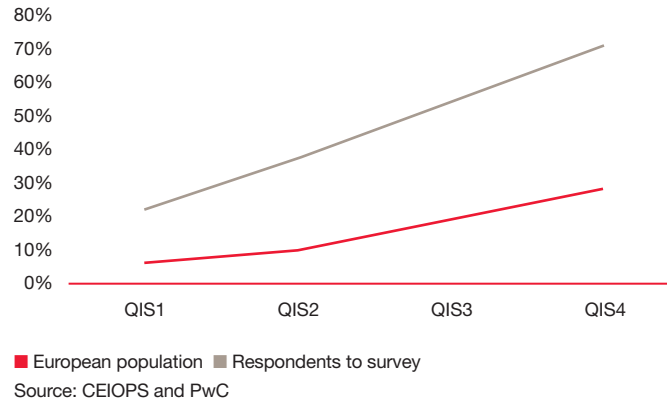
*Many insurers have deep concerns about the potential impact of a number of calibrations included in the QIS5 technical specifications.*

**Figure 1: Do you intend to participate in the QIS5 exercise?**



Source: PwC

**Figure 2: Which QIS exercises have you taken part in?**



Source: CEIOPS and PwC

**97%**  
of respondents say that they plan to participate in QIS5

# Ambition for Solvency II

*Respondents' ambitions for Solvency II go beyond basic compliance, though only a quarter see it as a source of competitive advantage.*

More than 70% of respondents want to achieve at least three goals (see Figure 1) on the back of their Solvency II project in addition to ensuring compliance. The results for larger and smaller companies are much the same.

More than 80% see Solvency II as an opportunity to improve risk management and 65% believe that it will help them to make more effective and efficient use of capital.

Only a quarter of respondents see Solvency II as a way to gain competitive advantage and these are generally larger organisations. Responses to the survey suggest that life insurers see more potential for competitive advantage than non-life and reinsurance companies.

## **Bringing stakeholders on board**

Many respondents are looking for wide input from within the business to help create their vision for Solvency II. Nearly half have engaged all key internal stakeholders in determining the organisation's vision for Solvency II and a further 38% have engaged a majority of internal stakeholders. Only 3% say that no internal stakeholders have been consulted.

However, more than 40% have no defined internal communications strategy for their implementation programme (see Figure 2), which brings into question the internal cohesion of the programme and the level of active involvement from the business in making it work. Some of these may be companies that have yet to get their projects underway, though a significant proportion state that internal stakeholders have been consulted. Without effective communication and active engagement, it will be difficult to change behaviour and instil Solvency II in the culture of the business.

Making the most of some of the broader benefits of Solvency II implementation will also require appropriate dialogue with external stakeholders such as analysts, rating agencies or industry bodies. However, the survey showed that there is relatively little focus on external stakeholder engagement at this stage, other than supervisor/government.



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This lack of engagement may be a matter of timing as there are still two years to go to before Solvency II goes live. It might also arise from the fact that many of the participants are relatively small subsidiaries of larger groups (external communication with certain stakeholders might therefore be expected to be organised at group level).

However, for smaller entities, the relative lack of engagement with industry associations raises questions about how well their interests are being considered in the debate over Solvency II.

As Figure 3 highlights, 71% of respondents say they have contacts with supervisors and governments: this is subject to further analysis in Section 7: Will the supervisors be ready for Solvency II?

### Promoting best practice and minimising costs

Realising the synergies with parallel initiatives such as Enterprise Risk Management (ERM) will be critical in managing costs and gaining the business and operational benefits. One of the key aims of Solvency II is to improve risk management. Close alignment with economic capital management would in turn support Solvency II's aim of introducing a risk-based and economically consistent regime.

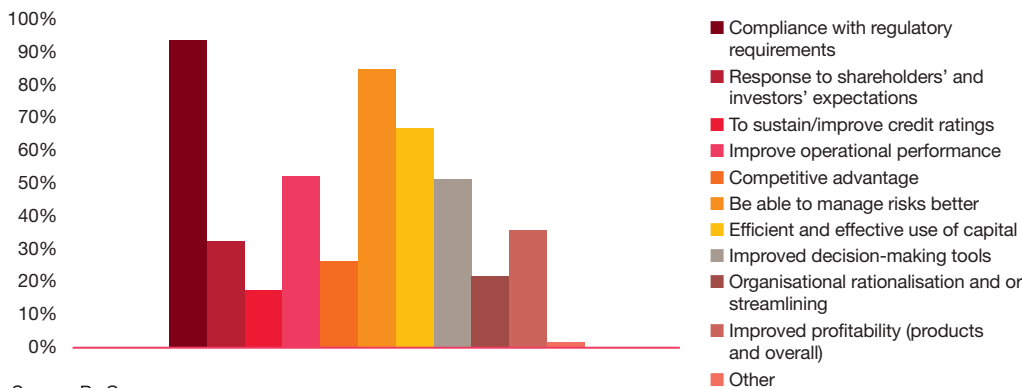
Most respondents are looking for convergence between their Solvency II and ERM projects (see Figure 4). A significant majority is also aiming for strong convergence between their Solvency II and Economic Capital projects.

Although it will not be directly replaced by Solvency II, the use of market consistent embedded value (MCEV) may diminish over time as Solvency II is further embedded. As Figure 4 highlights, fewer respondents are seeking 'strong' convergence with MCEV than other initiatives.

# 40%

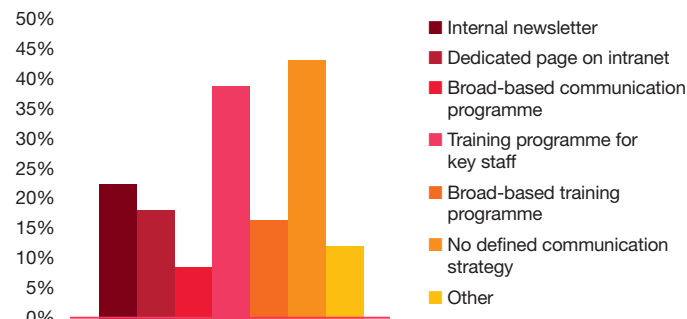
have no defined internal communication strategy

Figure 1: What are your main goals in implementing Solvency II?



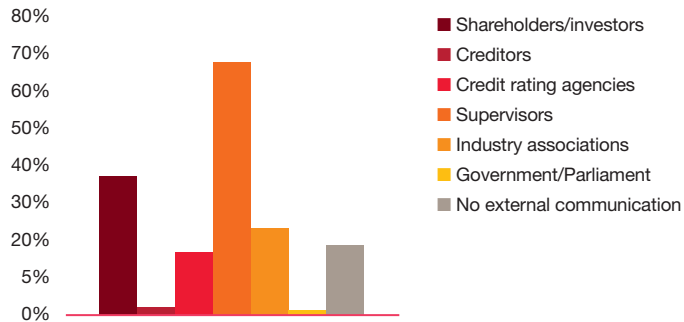
Source: PwC

Figure 2: What internal communications programme do you have in place for Solvency II?



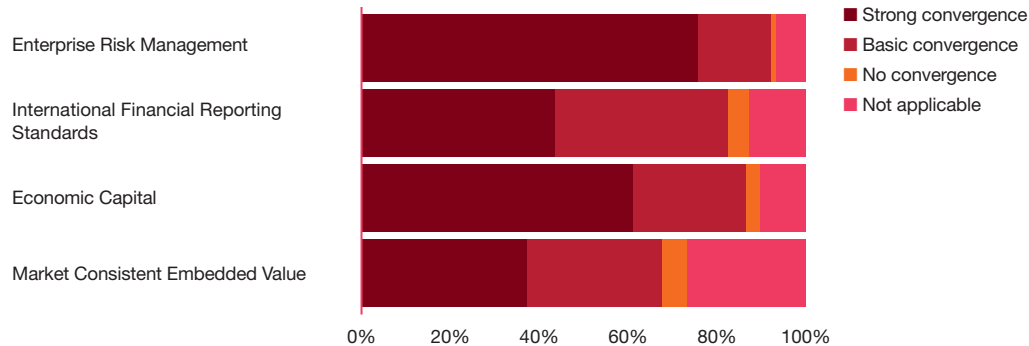
Source: PwC

**Figure 3: To which external stakeholders do you communicate progress on the programme?**



Source: PwC

**Figure 4: What level of convergence do you hope to achieve with other significant initiatives?**



Source: PwC

**76%**

*of respondents are looking for strong convergence with Enterprise Risk Management*

The results also show that a significant number of respondents want convergence between their Solvency II implementation projects and the implementation of the planned new insurance contract IFRS (IFRS Phase II), though noticeably fewer than for ERM or Economic Capital.

Clearly, the lack of clarity on the requirements and the timing of the IFRS Phase 2 rules make convergence harder. The new IFRS regime is due to go live at some point between 2013 and 2015. The International Accounting Standards Board (IASB) has recently said that it is aiming to finalise the standard in the second half of 2011, which should bring it into line with Solvency II timing. But uncertainties are likely to persist for some time, and clearly the European Commission has no plans to delay the Solvency II timetable to ensure alignment with IFRS Phase 2. Therefore, there is a risk that firms will need to revisit approaches adopted under Solvency II when IFRS goes live.

**Critical success factors**

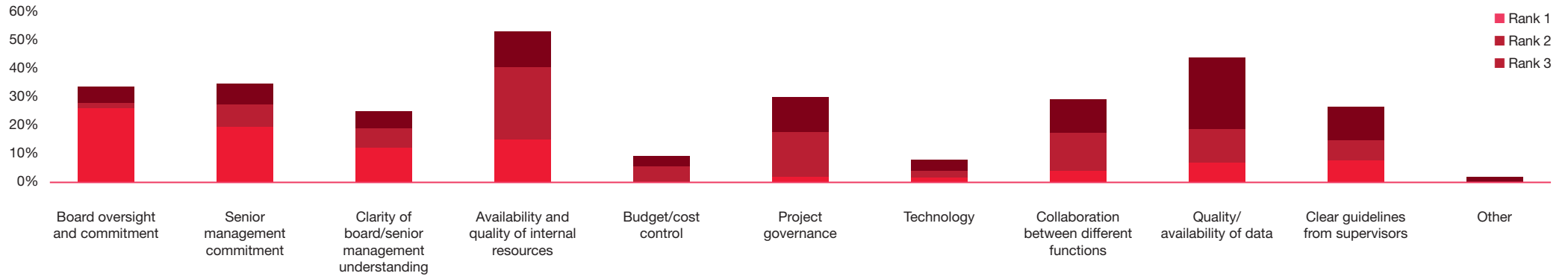
The availability and quality of internal resources and availability and quality of data are most likely to be included in respondents' list of the top three critical success factors for their Solvency II programmes (see Figure 5).

For many, however, the tone from the top is the ultimate determinant of success. Board oversight and commitment is ranked first more than any other category. Collectively, board oversight, board and senior management commitment, and the clarity of board/senior management understanding are rated higher than data and resources.

However, asked separately to rate the actual level of executive understanding of Solvency II, only 23% of respondents feel that it is high, 57% medium and 18% low.

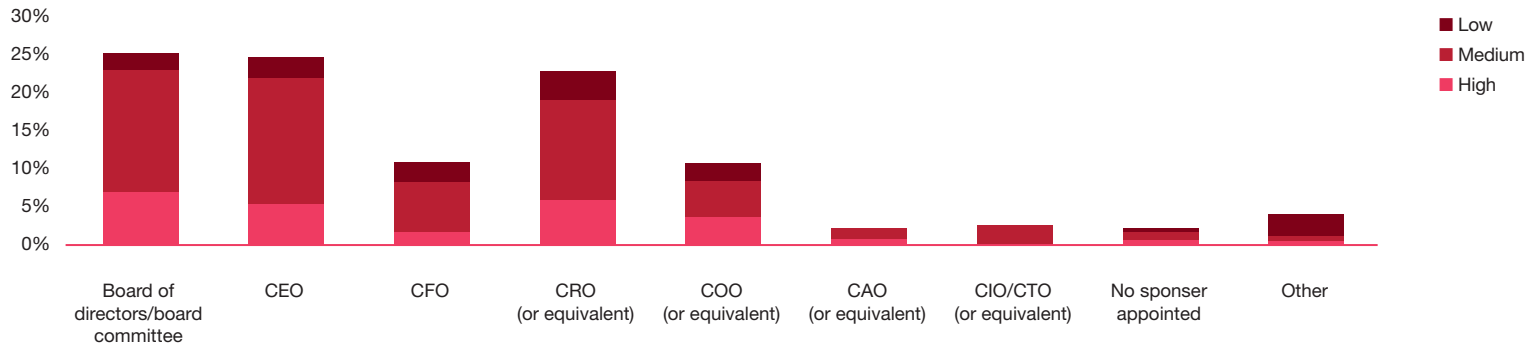
Board-level sponsorship and understanding are closely related (see Figure 6). The board is a project sponsor in just under half of those who indicate a high level of understanding. In contrast, the board is a sponsor in only a fifth of the 18% who indicate a low level of understanding.

**Figure 5: Rank the top three factors you believe are the critical success factors for successful implementation of the Solvency II programme**



Source: PwC

**Figure 6: Who within your organisation is the Solvency II 'sponsor' and what is the level of understanding of the board of directors?**



Source: PwC

# Coherence of project governance

*The survey findings raise questions about whether insurers are leaving enough time to tackle the more complex aspects of Solvency II and could therefore find themselves with an excessively tough and disruptive late push for the line. This is reinforced by the fact that the more progress respondents make, the more they realise they have to do.*

Solvency II establishes far-reaching governance responsibilities for boards of directors. Boards will have ‘the ultimate responsibility for the compliance, by the undertaking concerned, with the laws, regulations and administrative provisions adopted pursuant to this Directive’.<sup>3</sup> Given the range of these responsibilities once Solvency II goes live, board-level oversight will be crucial. The strategic implications of Solvency II and its operational impact on the organisation also underline the need for board members collectively to sponsor the cultural changes in line with the firm’s vision and ambition. At the same time, clear segregation of responsibilities over programme oversight and implementation is also crucial.

Most respondents report a clear understanding of the different roles to be played by the board and by senior management. In effect, 58% have different sponsors from those responsible for rolling out the programme.

More than 60% of respondents indicate that there is only one Solvency II project sponsor within their organisation. As highlighted in Figure 1, this is most frequently the board (as a collective) or the Chief Executive Officer (CEO), although Chief Risk Officers (CRO) and Chief Financial Officers (CFO) also featured. Of the 18% who indicate there are two project sponsors, the most usual combination is the board, together with the CEO or the CRO. Where dual sponsors exist, members of senior executive management (generally the CRO) are often also responsible for the roll-out of the programme. In addition, 71% of respondents have appointed a Solvency II project manager and a further 21% have plans to do so, leaving 8% with no project manager and no intention of having one.

## **Project status**

There is a fairly even split between respondents whose Solvency II implementation projects are underway (in some cases well underway), and those who are in the preparatory stages (gap analysis, programme mobilisation, implementation plan) or have not yet launched their projects (see Figure 2). However, nearly 40% of those who say they have not yet launched their projects are located outside the EEA (and therefore under no obligation to adopt Solvency II). Those in the preparatory stages are generally smaller firms, or smaller entities within groups (which are not necessarily material to the group overall). Generally, there are no clear geographical patterns in terms of project status. The most advanced respondents (between 51–75% complete) come from France, Germany and Belgium.



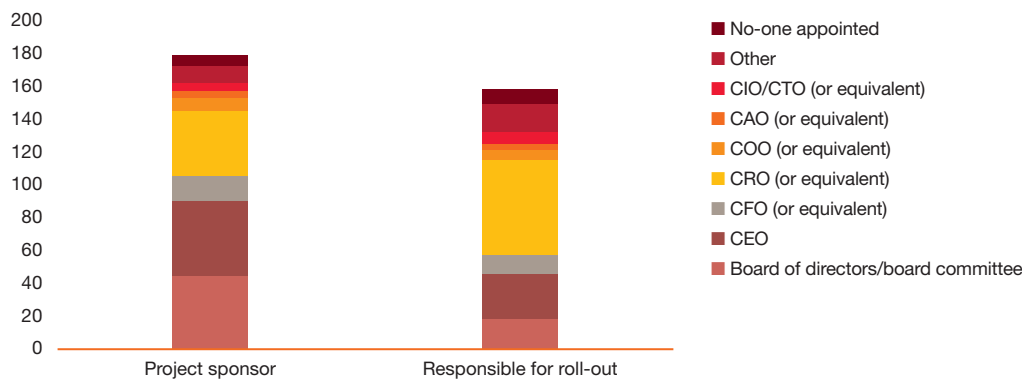
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*Lack of detail of the Level 2 measures, and indeed the associated Level 3 binding technical standards and guidance, can impede programme progress at the more advanced stages.*

Given that close to half of the respondents are still in the preparatory stages of the programme, their degree of confidence in meeting the 1 January 2013 deadline may be questionably high. Overall, most respondents indicate that they are 'quite confident' in meeting the deadline, suggesting some remaining concerns: an interpretation which is further borne out by other survey findings. However, discounting firms from outside the EEA, those in the preparatory stages are all relatively small entities. If they also lack complexity in the nature of the risk in the business, there is still time for preparation, but not much. Firms should not underestimate the time or effort involved.

As demonstrated in Figure 2, none of the more advanced respondents are 'very confident' that they will be ready on time: in effect, the level of confidence appears to reduce as a project progresses. This too suggests that the challenges of implementing Solvency II become more apparent the more advanced you are in the process, and when details begin to take on more significance. Lack of detail of the Level 2 measures, and indeed the associated Level 3 binding technical standards and guidance, can impede programme progress at the more advanced stages.

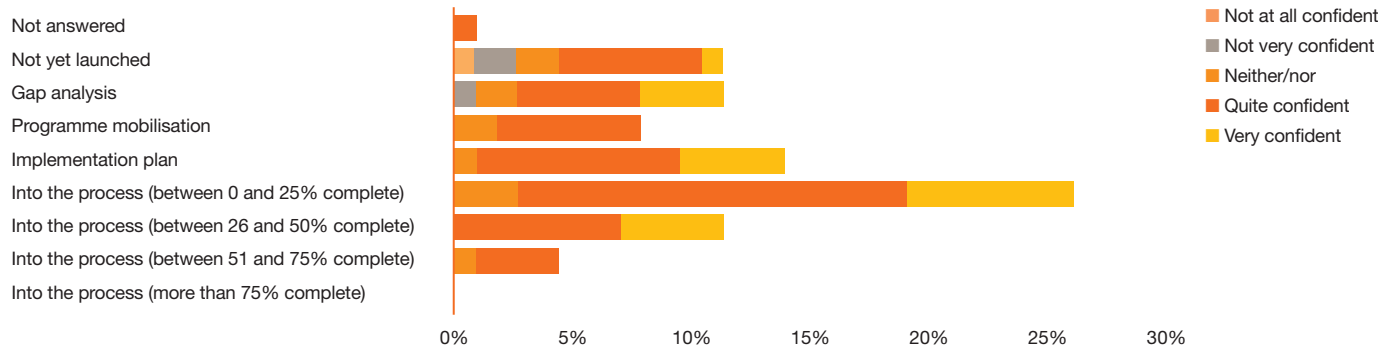
**Figure 1: Who is the Solvency II sponsor, and who is responsible for roll-out?**



Source: PwC

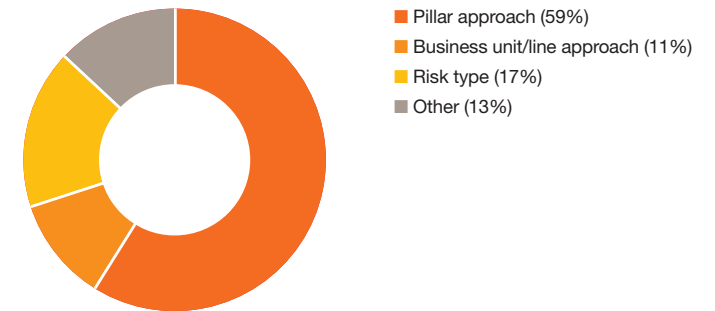
Nearly 60% of respondents have organised their programme approach around the three pillars of Solvency II, as opposed to an approach by business line, or by risk type.

**Figure 2: What is your current Solvency II programme status and how confident are you that you will be ready in time?**



Source: PwC

**Figure 3 : What is your overall approach to Solvency II?**



Source: PwC

### Project organisation

Nearly 60% of respondents have organised their programme approach around the three pillars of Solvency II, as opposed to an approach by business line, or by risk type (see Figure 3). A pillar-based approach should deliver an holistic approach for insurers operating exclusively in one business line (43% of respondents) and is perhaps necessary given that the level of certainty around the three pillars differs significantly at this stage. However, some recognise that it will be necessary to do a business line read-across when there are multiple business

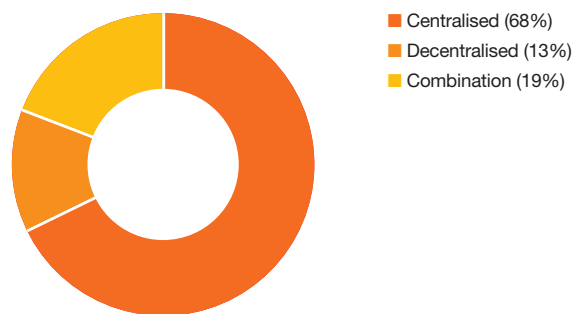
lines. Several respondents have combined a pillar approach with workstreams focusing on specific risk types.

The majority of groups have adopted a centralised approach to Solvency II implementation (see Figure 4). For larger organisations, this can entail a group programme or guidelines (with a project management office) which centralises certain processes (e.g. data management), but decentralises certain implementation. Some respondents note that decentralised activities are necessary to meet the expectations of local supervisors.

The responses indicate that respondents have mobilised, or are looking to mobilise, multi-competence teams for Solvency II implementation. Apart from the 5% who indicate no split between functions, the majority orchestrate the collaboration between different functions involved in Solvency II implementation.

For many, the approach also supports the broader goals discussed earlier in this report in terms of optimising synergies with other initiatives.

**Figure 4: If a group, is the overall approach centralised or decentralised?**

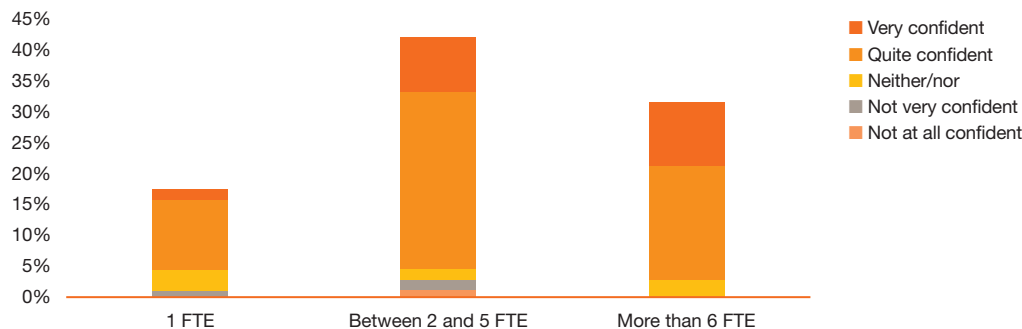


Source: PwC

### **Resources (human and financial)**

Figure 5 demonstrates that the majority of firms are confident they will be ready for Solvency II, with doubts creeping in amongst those with fewer than five full-time equivalents (FTEs) allocated. Of the 17% of respondents who indicate that one FTE has been assigned to Solvency II implementation, unsurprisingly the majority are entities with fewer than 200 staff. The majority also see the need for an additional (up to one) person year. However, a third are unsure of the additional resources needed.

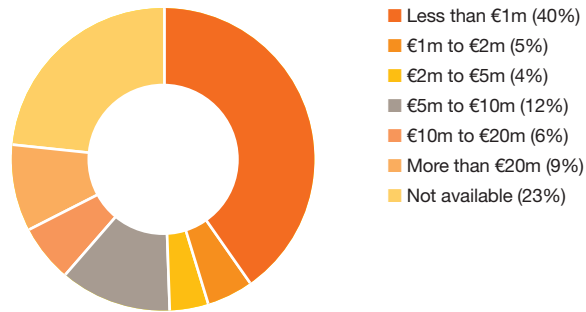
**Figure 5: How many resources do you anticipate dedicating full-time to the project at entity level and how confident are you that you will be ready when Solvency II goes live?**



Source: PwC

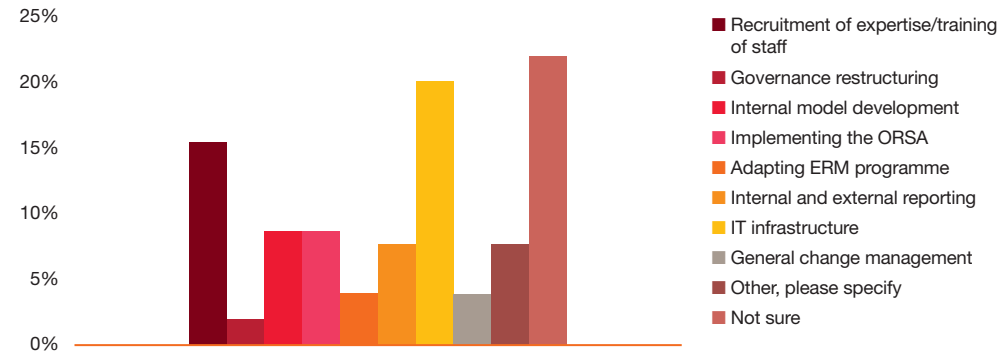
Of the 42% of respondents who anticipate dedicating between two and five employees to their Solvency II project full time, 70% are smaller companies with fewer than 500 staff at entity level, but 10% are large companies with total staff of between 1,000 and more than 5,000 staff. It should be noted, however, that over a fifth of the respondents who anticipate dedicating two to five employees to their Solvency II project full time have not yet launched their projects and so these numbers are estimates. More than 40% of this group feel that their project would require a further (up to one) person year of resources to successfully implement Solvency II, and 8% believe it would be more than this (one thought over four person years). Over a third of these respondents are unsure of the additional resources needed for implementation.

**Figure 6: What is your budget for Solvency II implementation overall? (in € millions)**



Source: PwC

**Figure 7: Where do most of the costs lie?**



Source: PwC

Of the 14% who have assigned six to ten FTEs to the Solvency II project, almost half have more than 1,000 staff and the majority of these respondents believe that more than one year of additional resource would be required. Even the 17% of, mainly large, companies who anticipate dedicating 11 to 20 FTEs or over 20 FTEs foresee the need for considerable additional resource; however, these respondents seem more certain of the level of resources required overall.

Also, given the complexity of Solvency II and the diverse skills required for its implementation, the level of staffing currently anticipated by many respondents appears to contrast with the broader goals for Solvency II implementation cited earlier.

There is a significant expectation that additional human resources will be required over and above the FTE assigned to the programme, and that, although the aim is to source much of this additional requirement from within the organisation, outside support is also likely to be needed. However, this

finding highlights questions already raised by some observers as to whether the necessary external resources will be available at the time they are required. Based on experience of other major regulatory-driven change projects (such as Basel II) a scarcity of external resources to support implementation as the deadline approaches may prove a major challenge.

Understandably, a significant number of respondents are unable to specify budget numbers as their projects are still in the preparatory stages (see Figure 6). However, there are other uncertainties over anticipated cost-cutting exercises and some respondents indicate that budgets are not set or costs are not systematically tracked within their organisations. It is worth noting, however, that budget/cost control is not seen as a significant critical success factor (see Figure 5 on page 9).

*Of those who have already launched their Solvency II programmes, 83% have spent less than 20% of their overall budget, indicating that the majority of the effort will come in the next two years. However, 57% of respondents do not have an annual breakdown of the budget.*

There are mixed views on where the major costs will lie (see Figure 7). Just over 20% believe that most costs will come from IT spend (although a significant majority of respondents think that less than 50% of the costs will be technology related). The second most highly ranked expenditure item (17%) relates to recruitment of expertise and/or training of staff. However, in line with the results above, a significant number of respondents (22%) are as yet unsure of the likely expenditure.

Of those who have already launched their Solvency II programmes, 83% have spent less than 20% of their overall budget, indicating that the majority of the effort will come in the next two years. However, 57% of respondents do not have an annual breakdown of the budget.

As with the level of human resources required for Solvency II implementation, the survey suggests a lack of clarity around budgetary requirements. There could be a number of reasons for this, for example:

- Most respondents (59%) indicate that budgets for Solvency II are allocated centrally (which could explain some lack of precision at a local entity level in the responses).
- Solvency II budgets may be bundled with those of other major initiatives (such as ERM or economic capital) and therefore it is difficult to put a separate price tag on them.

Clearly, expenditure on Solvency II is comparatively low to date for most. Of the 51% whose Solvency II projects are underway, this may be a result of a reluctance to move too swiftly given continued lack of certainty around the detailed rules in the Level 2 implementing measures (due spring 2011).

If this survey is in any way indicative of likely expenditure within the EU overall, the actual cost to the industry could be significantly higher than the €3 billion the European Commission originally estimated in its impact assessment.<sup>4</sup>

**59%**

*a majority indicate that budgets for Solvency II are allocated centrally*

# Focusing on the end game

*Most respondents are confident that they already meet the required standards of governance, though this would appear to be at odds with the fact that most believe that ORSA is still a significant challenge.*

Respondents believe the ORSA is set to be the biggest challenge in implementing Solvency II (see Figure 1). Internal model approval is second overall. The ‘use test’ is ranked third above the establishment and maintenance of the risk management function, suggesting that the latter is seen as relatively well developed already.

The fact that the ranking of the ‘use test’ is considerably lower than that for internal model approval suggests that some respondents already see this as intrinsic to internal model approval, while others perhaps lack an appreciation for how important passing the ‘use test’ is to getting internal models approved.

Respondents’ views of their supervisors’ main priorities are quite different (see Figure 2). Most see the primary focus as systems of governance, though this in some ways reflects respondents’ priorities as the ORSA and the ‘use test’ could be seen as an integral part of this. This is followed by the quality of internal modelling, and then data quality and/or internal control frameworks for data collection.

From these responses, it would appear that the respondents are focusing on the more immediate challenges, depending on where they are in the process.

The ORSA is fundamental and underpins a firm’s overall approach to Solvency II: it is not surprising that firms in the preparatory stages are currently focusing on it. However, firms whose Solvency II programmes are underway have also been confronted with uncertainty over supervisors’ expectations on the ORSA, and, bearing in mind how important the ORSA is in the overall process, ongoing lack of clarity in this area may impede progress (or incur additional cost if this has to be revisited later).

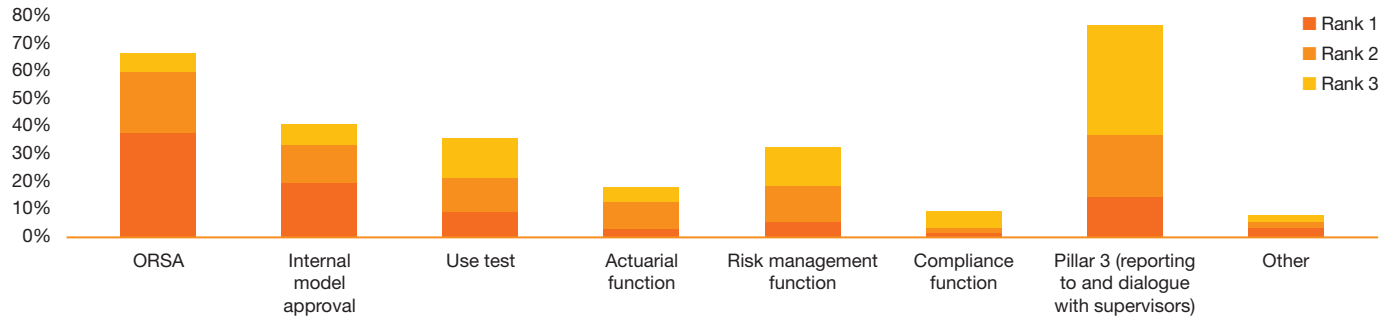
Across Europe, groups are currently going through internal model pre-approval processes with their home supervisors (just over a third of respondents are seeking pre-approval). This is something of a learning process for both supervisors and the applicants, particularly where group models are involved, and is proving challenging in some circumstances.

Given the complexity of the Pillar 1 requirements, and the QIS5 exercise, there is relatively more attention on Pillar 1 than on Pillar 2 (in terms of governance frameworks generally, or in the case of internal model use, the ‘use test’).



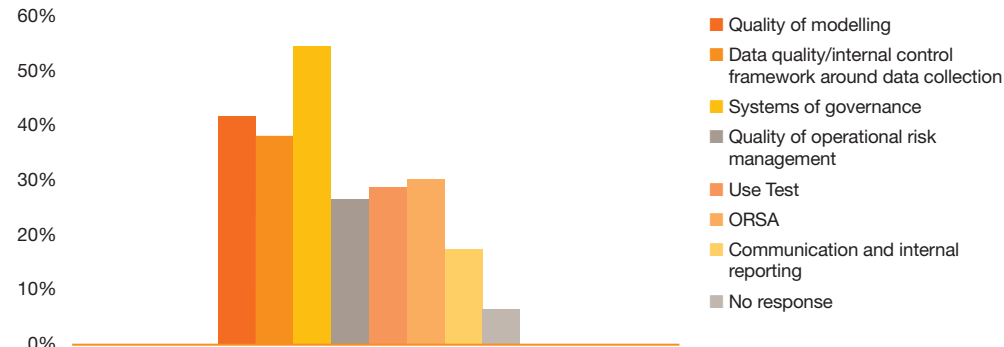
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**Figure 1: Rank the top three Solvency II elements which present significant challenges to the successful implementation of the Solvency II programme**



Source: PwC

**Figure 2: On which issues is your supervisor placing most emphasis in terms of implementation?**



Source: PwC

The results do raise questions as to whether all respondents have a clear picture of the ‘end game’, and indeed the ‘post-end game’ after Solvency II goes live. It is worth noting in this respect that the Report to Supervisors and Solvency and Financial Condition Report receive a relatively low ranking, though this may rise as more firms begin to address these areas and the scale of the challenge becomes clearer (see PwC’s *Countdown to Solvency II: Up to speed with reporting*, October 2010 - more details on page 29).

For illustrative purposes, we have aggregated the responses to ‘Report to Supervisors’ and ‘Solvency and Financial Condition Report’ under Pillar 3 (Figure 1). We have also included ‘Coherent dialogue with supervisors’ here, recognising that an important element of this dialogue will be reporting. In doing so it is clear that Pillar 3 is ranked the third most significant challenge individually, but the most significant in aggregate. This may be so for a number of reasons including lack of understanding of the reporting requirements and how they will work, proportionality, insufficient dialogue with supervisors or perhaps a fear of the additional level of exposure to competitors and shareholders by the public nature of the Solvency Financial Condition Report.

## Governance framework

An explanation for the apparent lower priority given by respondents to their systems of governance is that they are already quite confident that their current governance framework is compliant with Solvency II requirements (see Figure 3). They are particularly confident about their actuarial functions (72% are quite confident or very confident that these are now compliant).

Some doubts set in with regards to interaction between different control functions and the transparency of communication (only 52% and 48% respectively are quite or very confident here).

Nearly 50% of respondents currently outsource some activities, with a further 10% intending to do so in the future. Outsourced activities often include ‘non-core’ services such as IT services, investment management services, payroll services and claims handling, but also internal audit, the actuarial function, risk management and the compliance function (all parts of the system of governance under Solvency II).

The Directive makes it clear that insurance companies will remain ‘fully responsible for discharging all their obligations under the Directive when they outsource functions or any insurance and reinsurance activities’.<sup>5</sup> The fact that some key functions are outsourced does not affect the level of confidence of the relevant respondents with regards to Solvency II compliance.

Although, as mentioned above, some respondents indicated that outsourcing mainly involves ‘non-core’ services, there are elements of these services that will need careful review once Solvency II becomes compulsory. IT, for example, will be crucial in ensuring the quality of data. Given the total balance sheet dimension to Solvency II, outsourced investment management services may take on added importance overall. Even claims handling may require some reconsideration, given the overriding objective of Solvency II to improve policyholder protection.

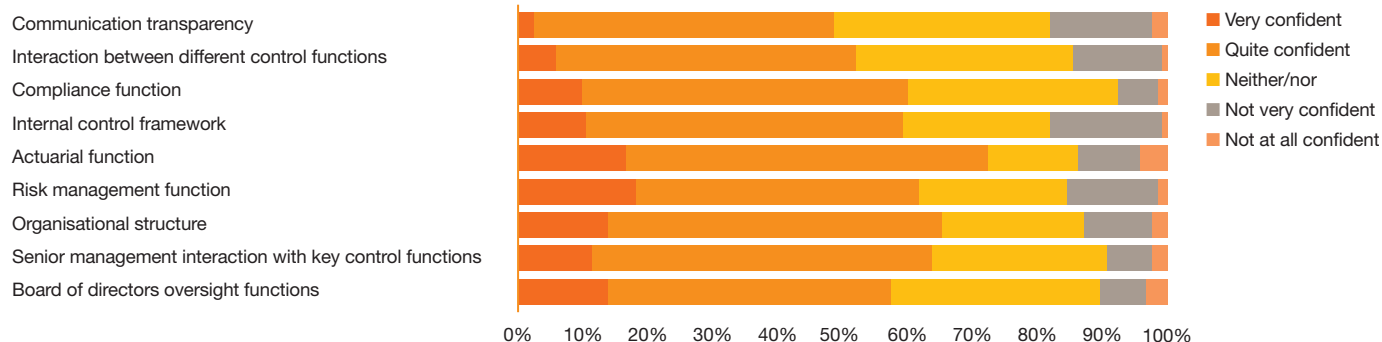
## Is this confidence over governance justified?

Firms’ approaches to Pillar 2, including their systems of governance, and the effectiveness and consistency of decision-making tools to determine strategic and day-to-day business, are likely to be considered more important than Pillar 1 – by supervisors, credit rating agencies and investors. As the responses indicate, this is an area of already considerable focus

# 65%

*of respondents will use the Standard Formula when Solvency II goes live*

**Figure 3: How confident are you that your current governance framework is compliant with Solvency II requirements?**



Source: PwC

for supervisors, and is likely to continue to be long after Solvency II goes live.

Clearly, the distinction between Pillar 2 requirements of the Solvency II programme and an ERM programme may become blurred, but firms should keep sight of supervisors' evolving expectations in this regard. This is an area where supervisory guidance is 'principles-based', rather than detailed rules – an art rather than a science.

The concept of proportionality is of particular relevance to smaller insurers, though this principle is not about size, but rather about the nature, scale and complexity of risk in the business. If you can demonstrate and convince your supervisor that risk management systems are sufficient to mitigate or manage risk effectively then further additional scrutiny may be avoided. Additional guidance from the European Commission will be provided in due course.

### Internal models

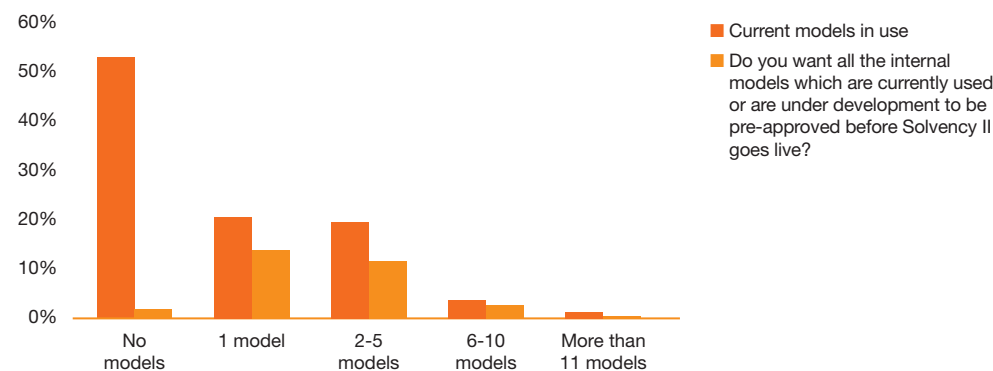
Nearly 50% of respondents currently use internal models (see Figure 4). The responses, however, show no clear patterns in terms of the relative size of companies using internal models or in which business areas they operate.

- 21% of respondents currently use just one internal model.
- 20% use between two and five models.
- 6% currently use over six models.

65% of respondents will use the Standard Formula when Solvency II goes live, indicating that a number of these models will be partial or that models will be used only at the group level. A quarter intend to use entity-specific parameters when using the Standard Formula.

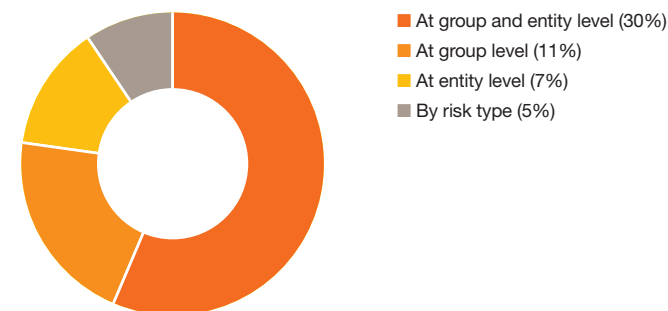
Figure 5 demonstrates that just over half of respondents plan to use internal models at the group and/or entity level, or by risk type when Solvency II goes live (although this may be solely to support the ORSA based on the lower percentage of those requesting pre-applications). Around a third intend to move to internal models at a later stage.

**Figure 4: Current model use versus planned model use**



Source: PwC

**Figure 5: Do you intend to use internal models when Solvency II goes live?**



Source: PwC

*Nearly 30% of respondents have registered for a regulatory pre-application programme for internal model approval. A further 9% are considering this, but have not yet registered.*

### **Internal model pre-application process**

Nearly 30% of respondents have registered for a regulatory pre-application programme for internal model approval. A further 9% are considering this but have not yet registered, either because the national pre-application process has not yet been launched, the entity is awaiting further information from their parent, the model itself is not yet defined, or because of a desire to analyse the potential implications of the QIS5 specifications before moving forward.

### **Data**

As seen earlier, a number of respondents flag the quality and availability of data as a critical success factor for their Solvency II project. There has been a well-publicised focus on data management and quality in the pre-application processes for internal model approval. The UK Financial Services Authority underlined this issue earlier this year: 'Data – firms must improve their data management and quality – we will assess firms' plans and ensure that their project planning is robust early in the pre-application stage'. However, data management and quality is also relevant for firms planning to use the Standard Formula: the theory that the nature of the output reflects the quality of the input never ceases to apply. The challenge of participating in the QIS has demonstrated the need for quality and specific data which are not always readily available. The need to improve data quality and management is not exclusive to firms planning to use models.

### **Responsibility for the calculation of SCR**

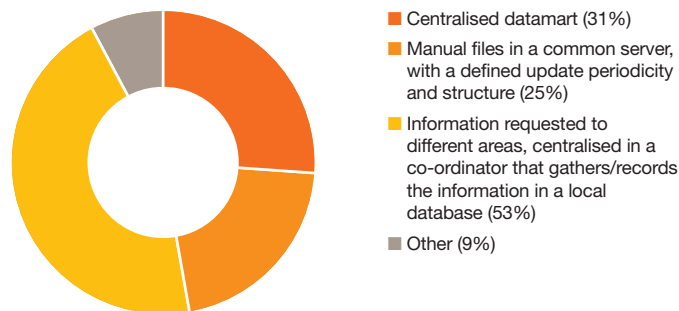
The actuarial function is most frequently responsible (38%) for the solvency capital requirement (SCR) calculation; followed by the risk management function (33%) and the finance function (17%). In 8% of entities, the responsibility is shared, often between the actuarial and risk management functions, but also between the actuarial function and the finance function. Responsibility in the remainder has not yet been determined.

### **Responsibility for data management and data quality**

In just over a half of respondents, only one function is responsible for data management and data quality within their entity. This is most frequently the IT function, but also the actuarial function or the finance function. The remainder indicate that multiple functions are responsible, often the IT function in combination with the actuarial function, the risk management (and operational risk management) function and/or the finance function. In some organisations, internal control also has a joint responsibility with other functions in this respect. A few respondents also stress that the business lines shared this responsibility.

Generally, respondents believe that data responsibility is unlikely to change as a result of the introduction of Solvency II. 5% of respondents do say that responsibilities will change, but from the perspective of increased responsibility for the different functions identified above.

**Figure 6: What mechanisms have been chosen for gathering and recording data for SCR/MCR calculation?**



Source: PwC

The approach used by the majority of respondents for gathering and recording data for the SCR/MCR calculations is relatively straightforward, using common servers or databases. Around 30% already use a central datamart: and others indicated their intention to move in this direction (see Figure 6).

### *Issues with data quality*

In spite of supervisors' publicly voiced concerns about data management and data quality, respondents do not have great concerns about the adequacy and quality of data either to improve or sustain their internal models. The majority of those using internal models for every type of risk are confident that they have sufficient quality data available to develop or sustain their models.

Respondents with market risk models are the most confident. Of the 57% of respondents modelling this risk, 83% are very or quite confident that they do, and would have, sufficient quality data. Of the 32% modelling counterparty risk, 81% are as confident. This confidence level drops in respect of life and non-life risk to 66% and 64% respectively; to 56% for operational risk; and to 55% for both health Similar to Life Technique (SLT) and health non-SLT risks.

**30%**

*have registered for a regulatory pre-application programme for internal model approval*

# 80%

*participated in the official QIS4 exercise in 2008 or have been through the exercise for their own benefit, and therefore should have a high level of knowledge in relation to data quality.*

# 43%

*rated quality and availability of data in their top three critical success factors*

**Figure 7: What are the key challenges regarding data management and collection?<sup>6</sup>**

	Critical	Extremely important	Important	No response	Total
Poor data quality	28%	11%	15%	3%	57%
Lack of historic data	12%	25%	18%	2%	57%
Lack of common terminology	9%	12%	20%		41%
Lack of documented data management procedures	14%	24%	22%	1%	61%
Other	1%	5%	3%		9%

The survey highlights issues around poor data quality and the lack of historic data as key challenges in data management and collection (see Figure 7). Many respondents also cite the lack of documented data management procedures as a major concern. There is a question about whether respondents' level of confidence is justified, given their concerns over data.

77% of respondents participated in the official QIS4 exercise and an additional 3% have been through the exercise for their own benefit. One can assume, therefore, that there is quite a high level of knowledge in terms of data requirements for Solvency II within this population. As this level of participation is significantly higher than the average for Europe as a whole, it cannot be assumed that this level of knowledge is widespread.

Knowing what data is needed for Solvency II is just the first step. As Figure 7 highlights, data quality, and the lack of historic data, are widely seen as significant challenges. Data quality will be crucial for internal model approval. Firms will need to be able to demonstrate that the required level of quality is realised and, where it is not achieved, improve it or explain why it does not reach the required standards.

But quality data is a general requirement, not just for those wishing to use internal models. Justification for using entity-specific parameters will rely on data quality and its demonstrability. Any future supervisory challenges to the calculation of the Standard Formula will be countered only by data that is accurate, complete and appropriate. No-one can therefore afford to be complacent about data quality.

*Data quality, and the lack of historic data, are widely seen as significant challenges. Data quality will be crucial for internal model approval; firms will need to be able to demonstrate that the required level of quality is realised and, where it is not achieved, improve it or explain why it does not reach the required standards.*

# Will supervisors be ready for Solvency II?

*In its July 2010 stock take on the preparedness of supervisors to implement Solvency II,<sup>7</sup> CEIOPS highlighted the different levels of progress among the supervisors surveyed and that supervisors are likely to require increased resources and reorganisation and further changes in supervisory methodology, tools and procedures in line with Solvency II.*

In spite of this, the majority of respondents (55%) believe their national supervisors have sufficient resources to perform the supervisory review under Solvency II effectively and appropriately for their organisation (see Figure 1). Risk-based supervision (and the proportionality principle) will obviously come into play here, but other survey results raised certain questions about respondents' ability to make this assessment.

For example, there is an unclear picture around the level of communication between respondents and their supervisors. More than 70% of respondents say they are communicating progress on their implementation programmes to their supervisors, and yet when specifically asked how frequently any discussions take place, 41% of respondents indicate that they discuss progress with their supervisors infrequently or not at all (see Figure 2). On the other hand, over a quarter indicate that dialogue is ongoing and a further 33% hold periodic discussions with their supervisors.

Those firms which have had no discussions with supervisors are all relatively small entities within a much larger group located in the EEA, or small national insurers. It is

understandable that the supervisors do not see such firms as a priority from a Solvency II perspective: however, those firms wishing to use an internal model should consider discussing their plans with supervisors to ensure no surprises later on.

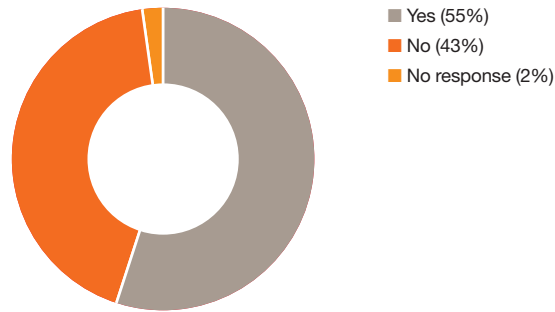
The situation changes somewhat amongst those respondents who say that dialogue with supervisors around Solvency II is infrequent (32%). Some are located outside the EEA, so the result here is understandable. However, the significant majority may want to have dialogue for the following reasons:

- 10% say they want to use internal models when Solvency II goes live and have registered for the pre-application process;
- a further 10% want to use entity specific parameters from Day 1; and
- 10% of these respondents are also relatively large, with 2009 sales (in terms of gross premiums) of more than €1.5 billion.

An infrequent dialogue in these cases does not appear so explicable, either on the part of the supervisors or the companies concerned. In effect, some of these entities are more significant from a national perspective than entities which indicate an annual dialogue with supervisors. Again, if these entities, particularly where they are subsidiaries, intend to use an internal model, they should consider embarking on some form of dialogue with their supervisors.

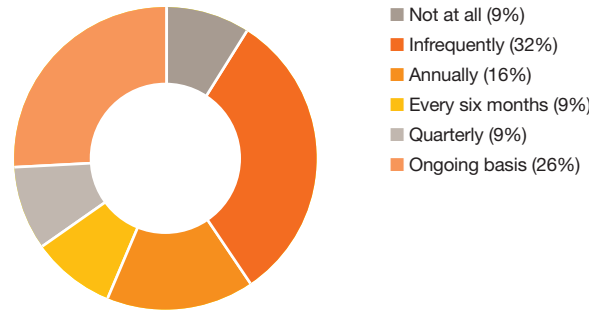
<sup>7</sup> Preparedness of insurance supervisors to implement Solvency II – CEIOPS publishes results of its stock taking exercise, 8 July 2010.

**Figure 1: Do you believe that your supervisor has sufficient resources to undertake the Supervisory Review effectively and appropriately for your organisation?**



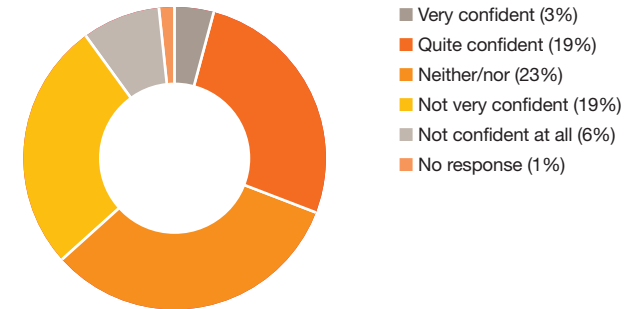
Source: PwC

**Figure 2: How frequently do you discuss progress with your supervisors?**



Source: PwC

**Figure 3: How confident are you that your supervisors will have the resources to undertake the validation process and approve all the internal models that you want to use when Solvency II goes live?**



Source: PwC

The nature of the communication between firms and their supervisors also appears insufficient. Asked whether supervisors have sufficient resources to undertake the internal model approval process, respondents' level of confidence dips significantly (see Figure 3). Only 22% are very or quite confident that their supervisor will have the resources necessary. Nearly a quarter are not confident. This reduced confidence is not surprising when you consider the 34% of respondents who say that they would like to use either all existing internal models or models under development when Solvency II goes live. This would mean that the minimum estimate, in relation to the respondents to this survey, for the number of models may exceed 70.<sup>8</sup>

If this were any kind of yardstick for the possible demand for model approval among the population of EU firms within the scope of Solvency II, this would imply the approval of a significant number of models before 1 January 2013.

Clearly there needs to be better communication between firms and their supervisors to ensure that expectations on both sides are realistic. Supervisors in a number of countries are already putting a significant amount of effort into the pre-application process: this may speed up the actual approval process later on – and the whole process in the future – as all involved become better acclimatised. But, at this stage, firms should have a better understanding of the likelihood of their being able to use internal models when Solvency II goes live, as this is fundamental to their implementation plans. This entails both their ability to ensure that their internal models achieve the proper quality standards (including the use test) and that supervisors will be in a position to review and, ideally, approve these models.

*Clearly there needs to be better communication between firms and their supervisors to ensure that expectations on both sides are realistic.*

8 Based on 34% of survey respondents looking for pre-application for between one and two models

# Profile of survey participants

**115**

companies from 22 countries  
have participated in the survey,

**43%**

of respondents  
operate exclusively  
in one business

**62%**

write life  
insurance; 70%  
write non-life;  
and 16% write  
reinsurance

**52%**

are located in  
the country where  
their group is  
headquartered;  
26% are  
headquartered in  
another EEA state

**25%**

are listed or  
plan to become  
listed in the  
next three years

**72%**

are limited companies or  
equivalent and 18% are  
mutuals or co-operatives

**78%**

form part of a  
group

**50%**

are subsidiaries

**8%**

are located outside the EEA – in Croatia, Switzerland or Turkey

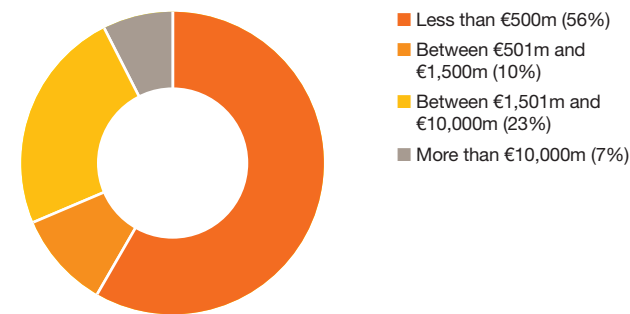
**42%**

have over 500 staff

**22%**

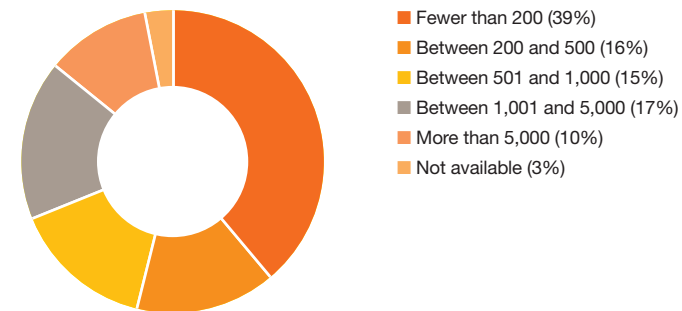
are part of groups whose 2009 group sales (gross premiums) are greater than €10 billion

**Figure 1: What were your entity's sales (in gross premiums) in 2009?**



Source: PwC

**Figure 2: How many staff in your entity?**



Source: PwC

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# Recent publications

## Getting to grips with the shake-up

October 2010



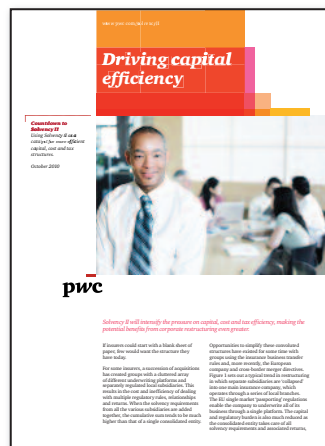
The parallels between Solvency II and the planned changes to IFRS open up valuable synergies in areas such as data management and model development. However, there are also crucial differences between the two regimes.

Insurers need to understand how these differences will affect the 'numbers' and how they can be reconciled and properly explained. Otherwise, firms could find themselves facing some challenging questions from analysts.

## Countdown to Solvency II

Countdown to Solvency II is PwC's flagship Solvency II publication, exploring the latest developments in Solvency II. It provides insight into key issues and assists insurers in assessing the implications of the Solvency II directive and in preparing for the changes ahead.

New articles launched October 2010:



**Driving capital efficiency: Using Solvency II as a catalyst for more efficient capital, cost and tax structures**

Solvency II will intensify the pressure on capital, cost and tax efficiency, making the potential benefits from corporate restructuring even greater.



**Driving the ORSA into decision making: Preparing the Own Risk and Solvency Assessment (ORSA) and building it into the running of the business**

The ORSA is set to be the main engine for embedding Solvency II into the business, requiring insurers to put a prospective view on their risks and their implications at the heart of decision making.



**Confidence in the model: Developing a framework for delivering reliable data and model assurance**

If insurers are not confident about the reliability of their data and the governance surrounding their models, they cannot be sure about the quality of the information coming out, and neither will their supervisor. How can insurers make sure that their models stand up to scrutiny?



**Up to speed with reporting: Keeping pace with faster turnaround time for supervisor returns**

The work needed to successfully deliver Solvency II won't end in 2012 as the required turnaround for quarterly returns is steadily cut from six to four weeks and reports to supervisors from 18 to 14 weeks between 2013 and 2015.



**Coming up with the numbers: Preparing a Solvency II balance sheet and managing the impact on market communications**

The Solvency II balance sheet will differ markedly from both current and future IFRS, creating significant technical, logistical and market communications challenges for European insurer.

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